CBO PAPERS

THE EXPERIENCE OF THE
STAFFORD LOAN PROGRAM
AND OPTIONS FOR CHANGE

December 1991

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

In this paper, all years are fiscal years unless otherwise noted.

Data presented in real (that is, inflation-adjusted) terms have been converted to 1990 dollars using the GNP fixed-weighted deflator.

Numbers in tables may not add to totals because of rounding.

PREFACE

Widespread attention has focused on the Stafford Loan program as its costs have grown rapidly. In response to a request by Senator Pete V. Domenici, Ranking Minority Member of the Senate Committee on the Budget, this paper examines issues pertaining to the reauthorization of the Stafford Loan program. In particular, it analyzes recent trends in the program and examines possible incremental options for reform. In accordance with the Congressional Budget Office's (CBO's) mandate to provide objective and impartial analysis, the paper contains no recommendations.

Constance Rhind of the Human Resources and Community Development Division and Deborah Kalcevic of the Budget Analysis Division prepared the paper under the direction of Nancy Gordon and Bruce Vavrichek. The authors gratefully acknowledge the contributions of Harish Chand, Jerry Davis, Cathy Ellman, Arthur Hauptman, Jamie Merisotis, Michelle Mrdeza, and Jay Noell. Computer assistance was provided by Tahirih Senne and Jacquelyn Vander Brug.

Frank Pierce edited the manuscript; Chris Spoor provided editorial assistance. Kimberly Guise and Julia Jacobsen produced the graphs. Ronald Moore provided administrative assistance for the project and prepared the manuscript for publication.

Robert D. Reischauer
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December 1991

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SUMMARY

In the 25 years since the inception of the first of the programs that now constitute the guaranteed student loan (GSL) programs, the federal government has become an important source of financial aid for students attending postsecondary schools. In 1990, it provided guarantees of over $12 billion on about 4.5 million loans and awarded more than $5 billion in grants to about 4 million students. GSLs include Stafford Loans, Supplemental Loans for Students, and PLUS loans (Parent Loans to Undergraduate Students).

Most GSLs are now made through the Stafford Loan program. In addition to insuring loans against default, the program provides substantial interest subsidies to borrowers and lenders because the federal government pays the interest costs on the loans while borrowers attend school, plus a portion of the interest costs after they leave school.

Growing pressures on the GSL programs have raised fears that they may not continue to be a viable form of student aid. Concerns have been voiced in three main areas. One concern is that costs are growing too rapidly. Total expenditures have more than tripled since 1979 in real (adjusted for inflation) dollars, rising to $4.2 billion in 1990. Another concern is that the default rate is too high. The annual default rate was about 7 percent in 1990, and is expected to rise significantly in 1991. At some institutions, the default rate is much higher than the average. Some observers argue that a high default rate demonstrates that the programs lack integrity--possibly indicating that some borrowers are receiving educations that provide them with little economic benefit while burdening them with loans that are difficult to repay. The resulting financial stress or lack of satisfaction with the programs may lead many of these borrowers to default on their loans.

A third concern is that the maximum loan in the Stafford Loan program has declined relative to the growing cost of postsecondary education. At $2,625 for first- and second-year students and $4,000 for other undergraduates (compared with an average cost of public education of $4,500), these loan limits may restrict the ability of some students to attend postsecondary schools or limit their choices to less expensive schools.

These concerns, plus the opportunity to reexamine federal student aid policy provided by the reauthorization of the Higher Education Act, have prompted some in the Congress to focus on the Stafford Loan program. Questions have been raised about how it could be modified to improve the outcomes for students and to reduce federal costs. This paper describes the operation of the Stafford Loan program and analyzes trends in its use and costs. It also considers a variety of specific options to help students or to reduce costs.

OPERATION OF THE STAFFORD LOAN PROGRAM

The Stafford Loan program is a decentralized system of lending in which banks lend to students attending postsecondary schools. State and private nonprofit guaranty agencies insure lenders against losses from default. In turn, these agencies are reinsured by the federal government. Borrowers pay no interest while they attend school, during a six-month grace period after they leave school, and during the time, if any, when they receive a deferment (that is, when they postpone loan repayment for reasons such as continuing education or unemployment). At other times, borrowers pay a fixed rate of interest on the loans. The rate of interest received by the lenders varies over time with market conditions and is 3.25 percentage points above the 91-day Treasury bill rate. The federal government pays the difference between the rate that borrowers pay and the rate that lenders receive.

The schools determine and verify the students' eligibility for the loans based on their families' resources and the costs of their educations. In disbursing the loans, the banks contact federally chartered guaranty agencies to have the loans certified as guaranteed. While borrowers attend school, the banks receive interest payments from the government and have few administrative responsibilities. After students graduate, the banks must be diligent in collecting payments on the loans.

Banks typically sell the loans in a secondary market, thereby increasing their ability to make additional loans. Some purchasers of student loans--including Sallie Mae (the Student Loan Marketing Association, a federally chartered, for-profit organization) and several large commercial banks--choose the loans according to the profit that they expect to make on them. State-level agencies also purchase loans to ensure that banks in their areas have sufficient funds to continue to lend to students.

Guaranty agencies insure the holders of student loans against default. The federal government, in turn, reimburses the guaranty agencies for most default losses, pays them a fee to cover part of their operational costs, and collects a reinsurance fee from them based on their default rates.

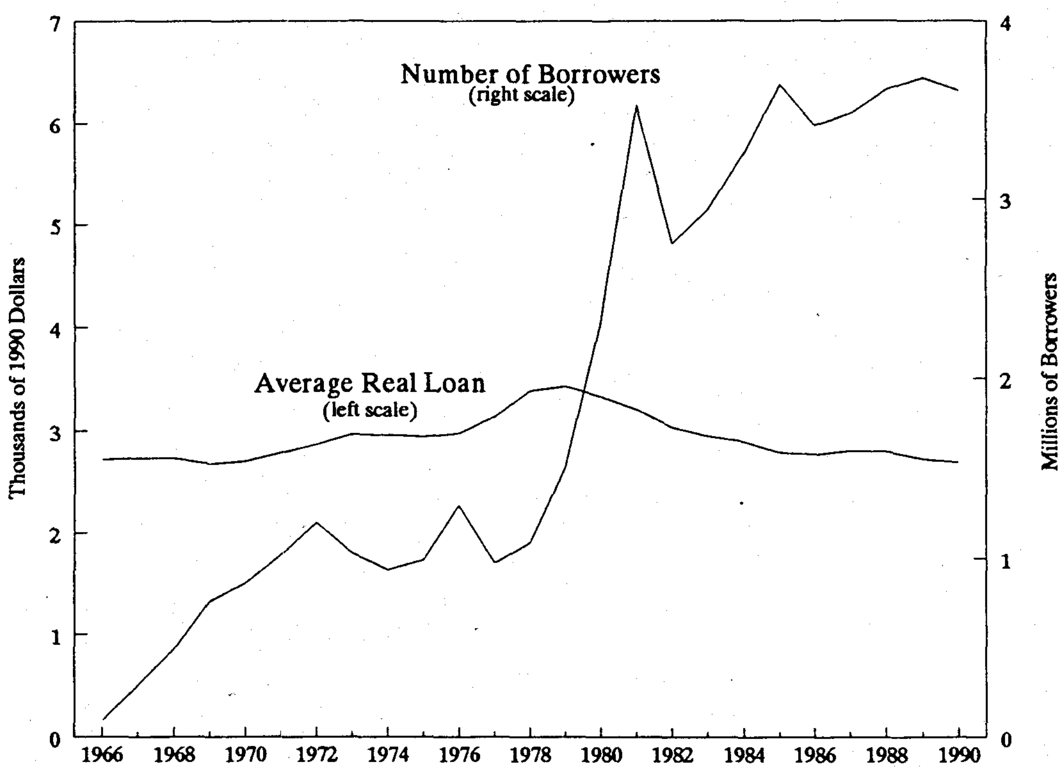
PROGRAM TRENDS

An increase in the number of borrowers--not an increase in the real average loan--has driven the growth in the Stafford Loan program. The number of borrowers has risen from an average of about 750,000 as the program became established to roughly 3.5 million annually since 1984 (see Summary Figure 1). Relaxing the eligibility standards between 1978 and 1981 to include students regardless of their family resources led to a large increase in the number of recipients. These patterns applied to borrowers attending all types of schools--public, private, and proprietary (that is, private for-profit schools that typically provide job training)--as shown in Summary Figure 2. In 1982, applicants again had to show financial need, leading to a drop in the number of new borrowers at public and private colleges. In contrast, the number of borrowers at proprietary schools has continued to increase.

Currently, 16 percent of all students attending postsecondary schools receive Stafford Loans. Students attending proprietary schools and private four-year colleges are the most likely to borrow, with 55 percent of all students at proprietary schools and about 25 percent of all students at private four-year colleges receiving Stafford Loans. Students from low-income families are considerably more likely to receive a Stafford Loan than are those from higher-income families, reflecting both their greater financial need and the income restrictions of the program.

Federal payments for net real interest costs, currently about $2.6 billion, have fluctuated considerably since 1979 as a result of changes in the Treasury bill rate and in the numbers of borrowers in school and repaying their loans (see Summary Figure 3). Net default costs, roughly $1.6 billion in 1990, have risen substantially since 1982, both because the number of borrowers repaying their loans has soared and because annual default rates have increased over parts of this period.

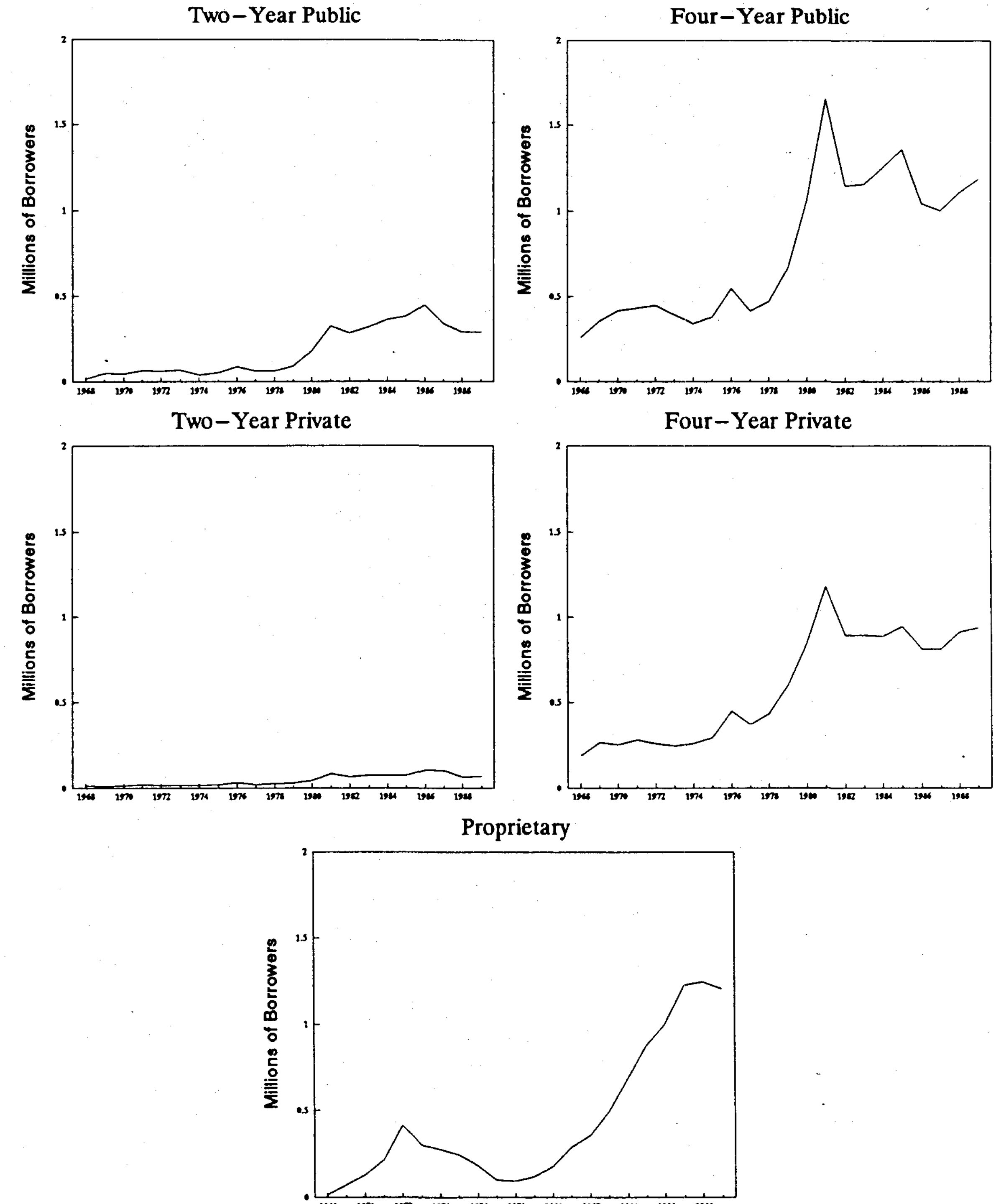
Summary Figure 1.
Number of Stafford Loan Borrowers and Average Real Stafford Loan, 1966–1990



SOURCE: Congressional Budget Office calculations based on data from Department of Education, "FY 1990 Guaranteed Student Loan Programs Data Book."

NOTE: Data refer to loans made in both the Stafford and the Federally Insured Student Loan (FISL) programs, although no new FISL loans have been made since 1984.

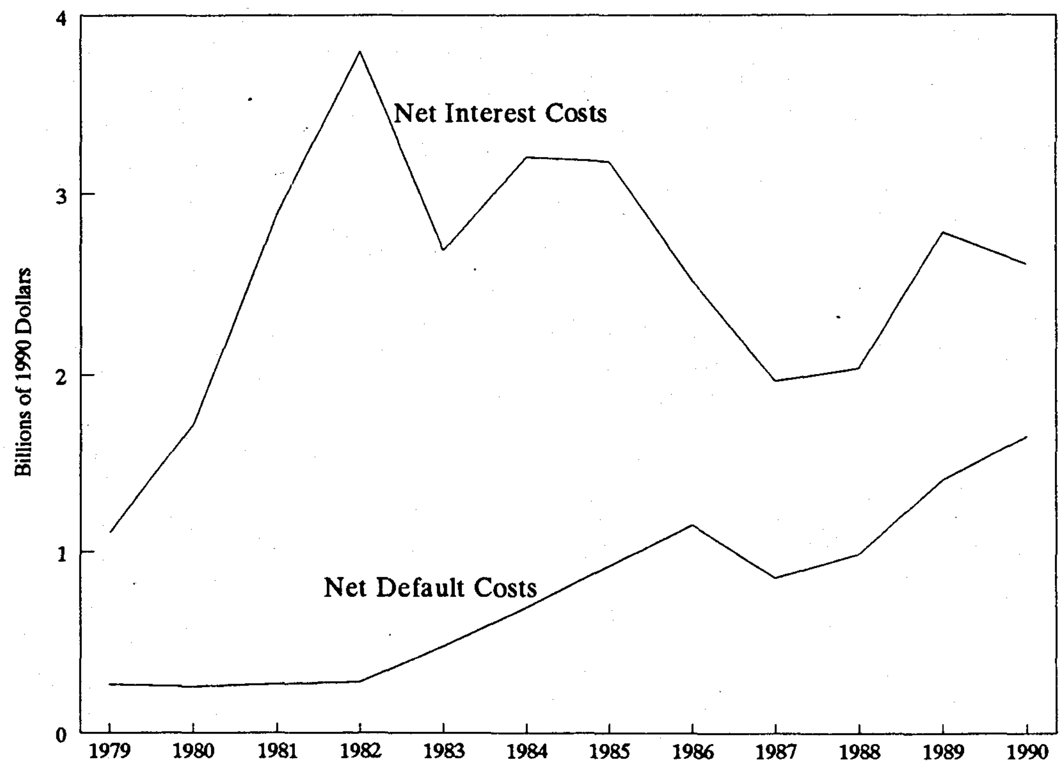
Summary Figure 2.
Number of Stafford Loan Borrowers, by Type of School, 1968–1989



SOURCE: Congressional Budget Office calculations based on data from Department of Education, "FY 1990 Guaranteed Student Loan Programs Data Book."

NOTE: Data refer to loans made in both the Stafford and the Federally Insured Student Loan (FISL) programs, although no new FISL loans have been made since 1984.

Summary Figure 3.
Net Interest Costs and Net Default Costs in the Guaranteed Student Loan Programs, 1979–1990 a/



SOURCE: Congressional Budget Office calculations based on data from Department of Education, "FY 1990 Guaranteed Student Loan Programs Data Book" and "Budget of the U.S. Government," fiscal years 1991 and 1992.

NOTE: Federally Insured Student Loans and Stafford Loans were known as "regular" guaranteed student loans (GSLs) until recently. Currently, the term GSL refers to those loans as well as PLUS loans (Parent Loans to Undergraduate Students) and Supplemental Loans for Students.

a/ See the text of the paper for a complete definition of these costs.

Students who borrow more, borrow for longer periods of time, borrow when interest rates are higher, or default on their loans account for larger shares of federal spending than do other borrowers. For example, the average recipient who completes four years of college or who attends graduate school borrows more than other recipients. In contrast to college graduates, the average borrower who does not complete a four-year college degree is more likely to default on a student loan. In general, students who borrowed during the early 1980s received greater subsidies than borrowers at other times because interest rates were higher then.

RECENT POLICY ACTIONS

The Omnibus Budget Reconciliation Act of 1990 made several changes in the budgetary context and operation of the GSL programs. These modifications will affect the ease with which future legislative changes can be made. The Budget Enforcement Act, a part of the Reconciliation Act of 1990, set new rules for federal spending through 1995 that potentially limit future changes in the Stafford Loan program. As an entitlement, the Stafford Loan program can now be expanded only if other entitlements are cut or if taxes or fees are increased. In addition, the trade-off between spending in entitlement programs and discretionary programs has been eliminated, because domestic discretionary programs now have a separate spending cap set forth in the new budget law. In other words, increases in spending on entitlements cannot be offset by reductions in spending for discretionary programs and vice versa. This feature is relevant for higher education programs because GSLs are entitlements while Pell Grants are part of discretionary spending.

The Budget Enforcement Act also changes the way that federal credit programs are reflected in the budget. Federal loan guarantees, such as those of the Stafford Loan program, were previously included in the budget on a cash-flow basis. Henceforth, the government's long-run cost, or subsidy, for a loan guarantee will be recorded as a budget outlay when the loan is disbursed. This change in accounting, which is part of broader changes under the rubric of credit reform, places loan guarantees and other federal spending on an equal footing.

The Reconciliation Act of 1990 also made several changes in the GSL programs, primarily to reduce their cost. These changes included eliminating schools whose former students have high rates of default, delaying the disbursement of loans to all first-time, first-year undergraduate borrowers, and requiring independent testing of federal student aid recipients without high school diplomas or General Education Development (GED) diplomas to see if they would benefit from further education. More recently, the Emergency

Unemployment Compensation Act of 1991 added wage garnishment as a tool that can be used in all states for collecting defaulted loans.

POLICY OPTIONS

Some observers assert that further modifications in the GSL programs should await the effects of recent changes. But many others argue that the programs continue to have serious problems that need to be addressed during this reauthorization.

This paper considers two categories of changes that the Congress could make in the Stafford Loan program--improving the outcomes for students and reducing the costs of the program. While broader suggestions have been made to change the mix of aid between grants and loans or to fundamentally restructure the GSL programs, they are beyond the scope of this paper.

Options to Improve the Outcomes for Students

Critics assert that the Stafford Loan program could better serve the needs of borrowers in a number of ways. Some people argue that the receipt of a Stafford Loan no longer allows borrowers the freedom of choice that was originally intended, since the costs of higher education outpaced the increases in the maximum loan during the 1980s. To correct this situation, they would increase the maximum loan available to students. Opponents of this option worry that many students are already burdened with large debts when they leave school, and that some of them will not have higher future earnings as a result of their educations.

Others suggest that some schools now encourage students to borrow by overstating the economic benefits of the education. When the borrowers are unable to find the jobs they expected, many default on their loans. Several options are available to address these concerns. Requiring all loan applicants to obtain counseling from independent centers could improve their understanding of their choices and help them to select institutions and programs that would be well suited to their talents and goals. Doing so would add to the bureaucracy of the program, however, and accomplish nothing for students who are well informed now. Strengthening the accreditation of postsecondary institutions has also been suggested by some who think that this could help reduce the incidence of fraud and abuse. Others argue, however, that the program needs better enforcement of existing rules and not additional regulations. Finally, requiring schools to share in the default costs of their former students might improve the outcomes for students because schools would then have a financial incentive to admit only those who can benefit from their education. Some schools might respond, however, by increasing tuition to all their students, rather than by improving the quality of their education.

Options for Decreasing the Costs of the Program

Other options would reduce the federal cost of the Stafford Loan program. Such changes could respond to the desire for additional spending on other high-priority programs (including more targeted spending on student aid) or for reducing the federal budget deficit. The federal government could, for example, further restrict the allowable cohort default rates of schools participating in the program. (A cohort default rate is the proportion of borrowers entering repayment who default.) Doing so could eliminate from the program schools that provide poor educations, but it could also eliminate some schools that provide high-quality educations but serve a large proportion of disadvantaged students.

Another group of options would reduce the federal subsidies that go to borrowers, lenders, and guaranty agencies. Currently many borrowers, particularly those attending graduate schools or four-year colleges, receive large interest subsidies. These subsidies could be reduced by requiring students to pay a larger share of their interest costs. Some students, particularly those not completing a four-year college degree, might be unable to repay the increased debt, however, and would either default on their loans or not take out the loans (and perhaps, therefore, not attend postsecondary school).

Subsidies to lenders could also be cut by reducing their 3.25 percentage-point premium above the 91-day Treasury bill rate. This rate is often much greater than their costs. Some smaller banks with higher costs would probably cease lending through the program if their premium were cut substantially, perhaps making borrowing difficult for students in some areas.

Finally, the administrative cost allowance provided to guaranty agencies could be eliminated, thereby reducing federal costs. A few financially insecure guaranty agencies might become bankrupt if this were done, however, thus potentially raising federal costs and leading to further questions about the integrity of the system.

CHAPTER I

INTRODUCTION

Mounting financial and operational pressures on the guaranteed student loan (GSL) programs have brought with them a growing sense of concern about this source of federal aid for students attending postsecondary institutions. Among analysts and the public alike, this concern has been generated by widely different perceived problems.

RISING COSTS

Some observers feel that costs are growing too rapidly. Total expenditures on interest subsidies and default payments more than tripled between 1979 and 1990 in real (adjusted for inflation) dollars--increasing from about $1.4 billion to $4.3 billion. This cost not only contributes to the overall federal budget deficit but, in the current budgetary environment, it precludes spending on other federal activities--including spending on education that is targeted to a greater degree on those with the lowest incomes.

RISING DEFAULT RATES

Some people are also worried about the default rate on GSLs. This annual default rate was about 7 percent nationwide in 1990 and is expected to climb in 1991. Moreover, it was much higher at many institutions, particularly proprietary schools (that is, private for-profit schools that typically provide job training) and two-year institutions. The high default rates at some schools may reflect a lack of program integrity. In other words, they may be a sign that some borrowers are receiving educations for which they are ill-suited or that provide little economic benefit, burdening them with loans to repay even though their earnings have not increased. The resulting financial stress or lack of satisfaction with their programs may lead many of these borrowers to default on their loans. Some critics charge that part of the problem is that the standards that schools must meet to participate in the GSL programs are too low and that the Department of Education is lax in its oversight of the accreditation of schools.

FALLING RELATIVE LOAN SIZES

A different type of concern is that the maximum available loan in the Stafford Loan program--by far the largest and most heavily subsidized of the GSL programs--has not kept pace with the rising costs of postsecondary education. At $2,625 each year for first- and second-year students and $4,000 each year for other undergraduates, these loan limits may restrict the ability of some students to attend postsecondary schools or limit their choices to less expensive schools. In 1973 (when there was a single maximum loan amount for all undergraduates), the maximum loan exceeded 100 percent of the average cost of public education and was about 80 percent of the average cost of private education for undergraduates.[1] By 1989, the maximum Stafford Loan had fallen to 60 percent of the average cost for first- and second-year students attending public schools and 90 percent of the cost for other undergraduates at these schools. For students attending private schools, the percentage of costs covered by the maximum loan fell to 20 percent for first- and second-year undergraduates and 35 percent for other undergraduates.

This paper examines these concerns about the Stafford Loan program and analyzes options for dealing with them.[2] The options described are all incremental ones, and do not include proposals to fundamentally restructure the program. The remainder of this chapter discusses Stafford Loans in the more general context of federal student aid.

FEDERAL LOANS IN THE CONTEXT OF FEDERAL STUDENT AID

Since the creation of the first GSL program in the mid-1960s, the federal government has played a substantial role in furthering the goal of equal educational opportunity. By providing student aid, the federal government has helped to increase access to postsecondary education for recipients with few financial resources and to expand the choices of other recipients in deciding among schools with different costs. The student aid that the federal government provides to achieve these goals consists of grants, work-study jobs, and loans.[3] These types of aid differ in the degree to which they subsidize

1. The maximum amount that a particular student may borrow, however, cannot exceed the cost of education for that student.

2. Wherever possible, data are for the Stafford Loan program. Where information for the Stafford Loan program is lacking, however, data are presented for the GSL programs together.

3. For an analysis of student aid packaging, see Congressional Budget Office, *Student Aid and the Cost of Postsecondary Education* (January 1991).

students. Grants are pure subsidies because they do not have to be repaid or earned. Work-study aid must be earned by its recipients. Loans subsidize borrowers to some degree because federal guarantees lower the interest rates on the loans and because the federal government pays part of the interest costs on most loans.[4]

Grants and Work-Study Aid

In 1990, the federal government provided grants totaling $5.3 billion to about 4 million recipients, and work-study aid of $600 million to about 850,000 students attending institutions of higher education. The largest federal source of grant aid is the Pell Grant program, through which about 90 percent of federal grant dollars are disbursed. Pell awards are based on financial need, and are targeted toward students from low-income families. Work-study aid is distributed largely at the discretion of schools' financial aid officers, subject to general federal guidelines.

Loans

Assistance in the form of loan guarantees and interest payments is another major form of federal aid to postsecondary students. The GSL programs provided guarantees of $12.3 billion on 4.5 million new loans in 1990.

In this paper, GSLs include three distinct groups of loans made primarily by banks:[5]

- Stafford Loans are heavily subsidized loans made to undergraduate and graduate students. These loans are awarded on the basis of financial need.

- Supplemental Loans for Students (SLS) are less subsidized loans made primarily to graduate students and independent undergraduates.

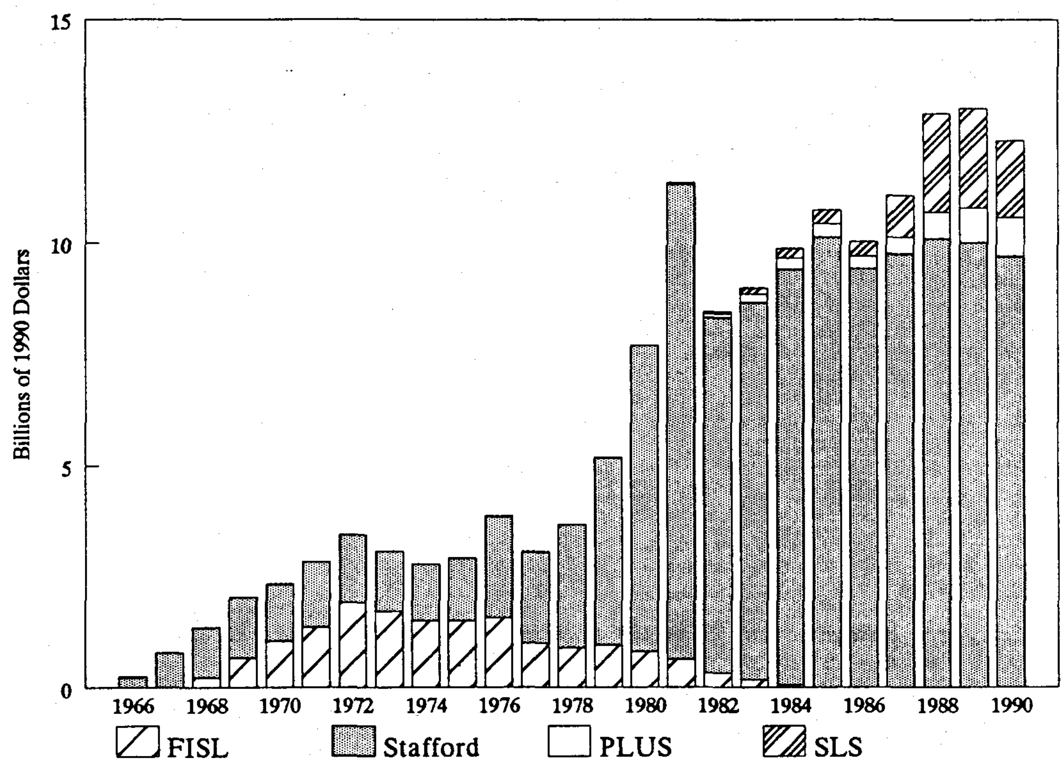
4. The federal government provides few direct student loans. Rather it provides loan guarantees and interest benefits. In this paper, loan guarantees are often referred to as loans for ease of exposition. When the distinction matters, it is made explicit.

5. Federally Insured Student Loans were formerly an important category of heavily subsidized loans. While no new loans are currently made in this program, some borrowers are still repaying these loans.

- PLUS (Parent Loans to Undergraduate Students) loans are similar to SLS loans in that they are also less subsidized. They are made to the parents of dependent undergraduates.

The relative importance of these loans has changed considerably since the inception of what are now known as Stafford Loans in 1966 and Federally Insured Student Loans in 1968 (see Figure 1). During the early and mid-1970s, these two programs each provided the guarantees on about one-half of federally insured borrowing that was based on the financial needs of the students. Legislative changes then led to expansion in the Stafford Loan program. Loan volume grew dramatically between 1978 and 1981 as eligibility was extended to all students irrespective of their families' financial resources. In 1981, growth in the Stafford Loan program halted temporarily when needs testing was reintroduced. The government created SLS and PLUS in the early 1980s, giving students and their families additional borrowing availability regardless of their resources.

Figure 1.
The Real Value of Loans Newly Guaranteed Through the Guaranteed Student Loan Programs, by Program, 1966–1990



SOURCE: Congressional Budget Office calculations based on data from Department of Education, "FY 1990 Guaranteed Student Loan Programs Data Book."

NOTE: Federally Insured Student Loans (FISL) and Stafford Loans were known as "regular" guaranteed student loans (GSLs) until recently. Currently, the term GSL refers to those loans as well as PLUS loans (Parent Loans to Undergraduate Students) and Supplemental Loans for Students (SLS).

CHAPTER II

THE OPERATION AND OUTCOMES OF THE STAFFORD LOAN PROGRAM

The Stafford Loan program helps to ensure that funds are available for students to pay their expenses to attend postsecondary institutions. About 9,300 commercial banks, savings and loan institutions, and credit unions currently participate in the program, lending to about 3.6 million students each year.

HOW THE PROGRAM WORKS

Current law mandates that the federal government pay the interest costs on Stafford Loans while students are in school and that it pay a portion of those costs as students repay their loans after leaving school. The federal government also reinsures agencies that have been established to guarantee these loans against default.

The Student's Role

Students first apply for need-based aid with financial aid offices at postsecondary schools they plan to attend. Once their eligibility is determined, they borrow from local lenders. Visits to the lenders are often unnecessary, as students can receive their loans directly from the schools, which act as intermediaries.

Students in their first two years of school may borrow up to $2,625 per year to attend approved postsecondary institutions (those that are accredited and that have cohort default rates of less than 35 percent), while other undergraduates may borrow up to $4,000 in each year (see Box 1 for a discussion of default rates). Students may now borrow up to $17,250 in Stafford Loans during their undergraduate years--an amount equal to two years at $2,625 and three years at $4,000. Graduate and professional students may borrow up to $7,500 annually with a maximum allowable total borrowing of $54,750 for all postsecondary education. This means that students who received the maximum Stafford Loans for five years as undergraduates can obtain $7,500 a year for five more years.

BOX 1
Definitions of Default Rates

Different needs in the analysis of federal student loan programs have led to the development of at least three measures of default rates on student loans. The three rates used most frequently in the education policy community are defined as follows:

Cumulative default rate =

$$\frac{\text{value of loans that have ever defaulted}}{\text{value of loans that have ever been in repayment}}$$

Annual default rate =

$$\frac{\text{value of new defaults in a given year}}{\text{value of all loans in repayment during that year}}$$

Cohort default rate =

$$\frac{\text{number of borrowers entering repayment who default}}{\text{number of borrowers who enter repayment}}$$

By convention, the first two rates compare the dollar values of defaults and loans in repayment, while the third rate compares the number of borrowers defaulting on loans with the total number of borrowers entering repayment. The first two rates are also frequently calculated net of default collections by removing any collections of previously defaulted loans from the numerators of the ratios. See Appendix A for a numerical example showing the relationship between these rates.

The Department of Education commonly reports the cumulative rate, which represents the experience of the program since its inception. In 1990, this rate was 15.3 percent for the GSL programs, or 10.4 percent when collections of previously defaulted loans are removed. This rate is an inappropriate measure of the current program outcomes because it includes all past loan and default amounts. The longer the program is in existence, the smaller is the influence of the last few years' activity on this rate.

The annual default rate shows the experience of the program in a given year and can be lower or higher than the cumulative rate. In 1990, the annual default rate in the GSL programs was 7.1 percent. Taking account of collections during 1990 on previously defaulted loans, the net annual default rate was 4.9 percent. The annual default rate is comparable to the default rate generally used by financial institutions and is argued by some to be the most appropriate rate for determining the current financial direction of the program.

The cohort default rate is used to determine the eligibility of postsecondary schools for the GSL programs. It compares the number of students entering repayment in a given year who default on their loans within one year to the total number of borrowers entering repayment in that year. Under current law, if a school has a cohort default rate of 35 percent or more during each of the last three years, students attending that institution are not eligible for student loans. In 1986, the cohort default rate for the nation as a whole was 24.7 percent. Since many defaults on student loans are thought to occur shortly after students enter the repayment period, this measure is argued to be an appropriate one for determining a school's eligibility because it reflects the experiences of students who recently attended the school.

The federal government pays the interest while the borrowers attend school and during a six-month grace period after the borrowers leave school. Some borrowers are also eligible to defer repaying their loans either just after the grace period or later in the repayment period. During this time the federal government pays all of the interest costs. Deferments are available to borrowers if, for example, they return to school, they are medical residents, they are on active duty in the armed forces, they serve in the Peace Corps, they or their spouses have a temporary total disability, they are on parental leave, or they are unemployed. Borrowers who are permanently and totally disabled can have their loans forgiven.

After the grace period and any deferments, borrowers who initiated their loans after 1988 pay 8 percent interest per year for the first four years they are repaying their loans and 10 percent per year thereafter. The federal government establishes these rates in legislation. Borrowers have paid interest rates of between 7 percent and 10 percent since 1968, depending on when the loans were obtained.

The School's Role

The schools determine students' eligibility for Stafford Loans based on their families' financial resources and the estimated cost of education. The Department of Education relies on schools to assure that their students are eligible for loans--for example, by verifying their reported incomes--and that they borrow no more than the loan limits.

Schools are required to notify lenders when their students graduate or drop out of the programs. Schools are also required to counsel borrowers when they disburse the loans and again when they leave the school. At both times, the schools must inform students of their obligation to repay the loans.

The Lender's Role

In approving Stafford Loans, the lenders contact guaranty agencies to have the loans certified as guaranteed. When students receive their loans, the lenders deduct 5 percent from the face value as an "origination fee" for the federal government. Banks can choose not to lend to some students, even if the students are eligible for loans. For example, banks may refuse to lend to all students attending specific institutions.

The rate of interest received by the lenders varies with market conditions and equals the bond equivalent of the rate of interest on 91-day